

State residency rules up in smoke as cannabis industry grows

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Cannabis' illegality at the federal level has created opportunities for the states to shape the legal landscape and create rules designed to capture the economic benefits of the cannabis industry for themselves while protecting their citizens against potential social harms. However, state residency requirements, used by many states to meet these goals, have been subject to a recent flurry of challenges based on the dormant Commerce Clause of the U.S. Constitution. The constitutional battles may change the course of the future of the industry, even after any federal legalization occurs.

As part of a highly regulated state cannabis system, residency may be required to acquire or hold a license, to own a cannabis business, or to be considered for inclusion in social equity programs.

In states with residency requirements, lenders should be aware of these challenges either to prepare for an emerging national market or to understand the risks created for borrowers who may subsequently be out of compliance with state laws.

The goals of residency requirements

Despite the lack of support from federal lawmakers, the cannabis industry continues to thrive. States have been leading the way, cultivating an industry composed of local markets. But cannabis commerce is beginning to show signs that it is outgrowing its provincial roots, and recent challenges to state residency requirements are reflective of this trend.

States have included residency requirements since 2012 when Colorado legalized cannabis. As part of a highly regulated state cannabis system, residency may be required to acquire or hold a license, to own a cannabis business, or to be considered for inclusion in social equity programs.

These measures were created for various reasons including: (1) ensuring state residents receive the economic benefits from the

cannabis industry; (2) deterring conversion of cannabis inventory to the black market; and (3) avoiding retaliation by the federal government.

The controversy

Although federal illegality of cannabis has created an opportunity for the states, as demonstrated by the recent decisions below, the U.S. Constitution's Commerce Clause, which empowers Congress to regulate commerce among the states, may be taken away.

More specifically, these courts have focused on the negative implication of the Commerce Clause. Known as the "dormant Commerce Clause," it raises concerns, as the Supreme Court pointed out in *Department of Revenue of Kentucky v. Davis* (2008), when "regulatory measures [are] designed to benefit in-state economic interests by burdening out-of-state competitors."

For that reason, several trial courts have, on a motion for a preliminary or permanent injunction, determined that certain residency requirements for cannabis licensing are likely unconstitutional under the dormant Commerce Clause.

In *Toigo v. Department of Health and Senior Services* (2021), the Western District of Missouri recently granted a permanent injunction restricting enforcement of Missouri's cannabis license residency requirement. The rule required medical cannabis businesses to be majority-owned by state residents for at least a year to apply for or to maintain a license.

On a motion for a preliminary injunction earlier this year in the same case, the court held that the rule likely violated the Commerce Clause. It explained that "[s]tate laws violate the dormant commerce clause if they require differential treatment of in-state and out-of-state economic actors...unless the regulation is narrowly tailored to advance a legitimate local interest." The court determined that the State did not demonstrate that the durational residence requirement was "narrowly tailored to advance its legitimate interest in crime prevention, much less that it ha[d] 'no other means' to advance that interest."

Similarly, in *Lowe v. City of Detroit* (2021), the Eastern District of Michigan granted a motion for a preliminary injunction against enforcement of Detroit's recreational marijuana licensing ordinance, which granted preferential treatment to "Detroit legacy" applicants.

These were applicants who had lived in the city for at least 10 years. The judge found that “[a]s presently drafted, the ordinance is far more protectionist than it is equitable.”

Accordingly, the court held that the city’s ordinance process gave “an unfair, irrational, and likely unconstitutional advantage to long-term Detroit residents over all other applicants.” Therefore, the plaintiff showed a substantial likelihood of success on her dormant Commerce Clause claims.

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However, other courts have dodged the constitutional question. The Western District of Oklahoma in *Original Investments, LLC v. Oklahoma* (2021) avoided ruling on the merits of the underlying constitutional claim and granted the State’s motion to dismiss based on the affirmative defense of illegality.

There, the non-resident plaintiff sought a medical marijuana business license. They challenged the constitutionality of Oklahoma’s medical marijuana business licensing laws, which prohibit non-residents from receiving licenses and restrict non-resident ownership of an Oklahoma entity with a license to not more than 25%.

Rather than address dormant Commerce Clause issues, the Oklahoma court focused solely on the fact that the sale of cannabis is federally illegal (regardless of the state’s medical marijuana program). The federal court refused to “use its equitable power to facilitate conduct that is illegal under federal law.” The court concluded that “[g]ranted plaintiff the equitable relief it seeks here would facilitate criminal activity more (by allowing non-residents to

have medical marijuana business licenses) than would a denial of equitable relief.”

The issue may soon be decided

As the trial courts above have not rendered final judgment on this issue, all eyes are on the 1st U.S. Circuit Court of Appeals which is poised to review the 2021 decision in *Northeast Patients Group v. Maine. Department of Administrative & Financial Services*. This would be the first circuit court to take up the issue.

In this case, the District Court of Maine enjoined Maine’s Department of Administrative and Financial Services from enforcing the state’s dispensary residency requirement, holding that it violates the dormant Commerce Clause. The defendants argued that the residency requirement did not violate it because the purpose of the dormant Commerce Clause is to “preserv[e] a national market” and prohibit “state laws that interfere with that national market.” But here, the federal ban on marijuana effectively eliminated a national marketplace for it.

The court acknowledged that the defendants’ argument was “not without logic.” But, nevertheless, the court found it unsupported by case law and unconvincing given that the medical marijuana industry in Maine is not “wholly intrastate” and defendants did not show Congress had “unmistakably clear intent to allow otherwise discriminatory regulations.”

The judge noted that “where federal courts have confronted dormant Commerce Clause challenges to state or local laws that favor residents in the recreational or medical marijuana context, the courts have held that such laws are likely unconstitutional.”

Since that ruling, the District Court of Maine has stayed its own injunction preventing enforcement of the residency requirements while the First Circuit appeal is pending because of how disruptive and critical this ruling could be.

The Maine court’s words may foreshadow the beginning of the end for many state residency requirements as currently drafted. In the meantime, they remain a part of the complex set of rules and regulations with which cannabis-related businesses must comply, and that their financiers must monitor to protect the value of collateral and investments.

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